PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ENERGY DIVISION **RESOLUTION G-3348**
April 17, 2003

R E S O L U T I O N

Resolution G-3348. Pacific Gas and Electric Company (PG&E) requests approval of a shareholder reward in the amount of $7,690,297 as provided for under its Core Procurement Incentive Mechanism (CPIM) for the period November 1, 2000, through October 31, 2001 (Year 8). PG&E's request is conditionally approved.

By Advice Letter (AL) 2431- G. Filed on December 23, 2002.

SUMMARY

PG&E's request for a shareholder reward of $7,690,297 for Year 8 is approved, subject to the condition specified below. The utility is authorized to record the shareholder reward in the core and core subscription subaccounts of its Purchased Gas Account. The shareholder reward is warranted because PG&E's cost of procuring gas for its ratepayers was below the tolerance band as provided for under the CPIM.

The shareholder reward represents a reduction of $9,128,660 from PG&E's initial recommendation presented in its Year 8 Annual CPIM Performance Report. This change was due primarily to the utility's revision and disclosure of additional costs following the release of its report. As a result, the amount of the approved shareholder reward is consistent with the findings of the audit and evaluation performed by the Office of Ratepayer Advocates (ORA).

The shareholder reward is subject to future revision or forfeiture depending upon the outcome of the Commission's investigation into the causes of high California border gas prices in 2000 – 2001 (Order Instituting Investigation I. 02-11-040), and on the outcome of the Federal Energy Regulatory Commission's (FERC) investigation into electric and gas market price manipulation. Additionally, PG&E may revise the shareholder reward upon the resolution of certain financial and physical settlement costs currently in dispute.

Furthermore, PG&E is required to provide a report explaining the omission of any costs or reporting errors in the utility's Year 8 Annual CPIM Performance Report and to describe its current risk management accounting procedures related to core gas procurement. This report shall also identify any necessary improvements to its CPIM related accounting procedures and information processes to prevent reporting errors or omissions.

BACKGROUND

In D. 97-08-055 (Gas Accord), the Commission adopted the CPIM to provide PG&E with a direct financial incentive to minimize gas procurement costs while maintaining reliable service for its customers.[1] The basic concept underlying the CPIM is the use of a standard based on various published gas price indices to evaluate whether PG&E's gas procurement costs are reasonable. The incentive is manifested through the equal sharing of any gains or losses resulting from a comparison of the utility's gas costs with this standard by shareholders and ratepayers.[2]

The specific procedures and methods for calculating elements of the CPIM for the period under consideration are contained in a document titled the "PG&E/ORA Post-1997 CPIM Agreement".[3] Under this agreement, shareholder rewards or penalties are determined by comparing certain costs PG&E incurs procuring gas for its ratepayers to a "tolerance band".[4] The tolerance band is

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[1] The CPIM is described in the Gas Accord application (A. 96-08-043), in a filing entitled " Supplemental Report Describing the Post-1997 Core Procurement Incentive Mechanism (CPIM), dated October 18, 1996."

[2] With the exception of core aggregation customers, PG&E procured gas for its core customers during Year 8. PG&E procured gas for its core subscription customers until February 28, 2001, when this service was cancelled under the terms of the Gas Accord. The term "ratepayer" used in this resolution refers to these two classes of customer.

[3] The ORA-PG&E Memorandum of Understanding of December 17, 1998 includes PG&E/ORA Post-1997 CPIM Agreement implementation details and various modifications.

[4] Under the PG&E/ORA Post-1997 CPIM Agreement, all costs associated with the purchase of natural gas can be included as a cost of gas under the mechanism. Additionally, the agreement stipulates that certain costs such as gas commodity costs, capacity reservation charges (Transwestern pipeline demand charges are allowed only under certain conditions), volumetric transportation costs shall be considered a gas cost. Risk management transaction costs as well as resulting gains or losses are to be considered as a gas cost as well. The agreement also provides that out-of-

Footnote continued on next page

defined as a range of costs considered reasonable and is constructed around a benchmark representative of the market cost of gas at the PG&E citygate plus a storage cost component.[5] If PG&E's gas costs fall outside the tolerance band, there is a 50/50 sharing of this amount between the utility's shareholders and ratepayers. Thus, a shareholder reward is realized when gas costs are below the lower limit of the tolerance band and a shareholder penalty results when gas costs exceed the upper limit of the tolerance band. Ratepayers receive their portion of any sharing through gas procurement rates assessed by the utility. Costs falling within the tolerance band are considered reasonable and fully recoverable from ratepayers without further adjustment.[6]

On March 21, 2002, PG&E submitted its Annual CPIM Performance Report for Year 8. In the report, the utility identified its gas costs and provided a calculation of the benchmark and corresponding tolerance band. Using these factors, PG&E concluded that it was entitled to a shareholder reward of $16,818,957. In addition to these computations, the utility described its strategies using gas storage and risk management techniques to counter the severe price increases occurring during the winter of 2000/2001. PG&E's recommended shareholder reward presented in the report is summarized in the following table:

PG&E CPIM Year 8 Annual Report Performance Summary

Total Commodity, Transportation and Storage Costs						
Tolerance Band			Actual Costs			
Upper limit	Total Benchmark	Lower Limit	Total costs incurred	Amount under Benchmark	Amount under Tolerance Band	Shareholder Reward
$2,379,882,261	$2,336,124,088	$2,314,245,001	$2,280,607,087	$55,517,001	$33,637,914	$16,818,957

state gas sales, revenue from pipeline capacity brokering and similar revenue producing activities may be credited against the cost of gas.

[5] Under the PG&E/ORA Post-1997 CPIM Agreement, the benchmark is composed of a variable cost component and a fixed transportation cost component. The variable cost component consists of specified gas price indices plus volumetric costs to the PG&E citygate multiplied by the expected quantity of gas purchased at each index point. The fixed transportation cost component includes interstate and intrastate pipeline capacity charges. Storage costs are included in the benchmark through a proscribed injection and withdrawal rate.

[6] PG&E A. 96-08-043, Supplemental Report Describing the Post-1997 Core Procurement Incentive Mechanism (CPIM), dated October 18, 1996, page 2-10. See also Preliminary Statement Part C. 13 in PG&E's gas tariff.

On December 17, 2002, ORA submitted its Monitoring and Evaluation Report of PG&E's Year 8 CPIM performance. In the report, ORA stated that it conducted a thorough investigation, evaluation and audit of PG&E's gas procurement costs and shareholder reward calculation. Audit findings confirmed that PG&E's gas costs were below the tolerance band and that gas commodity and transportation costs in the amount of $2,292,875,561 are recoverable from ratepayers as specified under the CPIM agreement. According to its analysis and in consideration of additional information furnished by PG&E, ORA determined that the utility's shareholder reward should be $7,690,287, resulting in a reduction of $9,128,660 from the amount determined by PG&E in its report.

The difference between ORA's shareholder reward computation and PG&E's initial determination is due to an upward revision of the utility's gas costs and an accounting adjustment. Gas costs were revised because of a reporting error found on PG&E's financial swap and termination estimate of $12,268,474.[7] The accounting adjustment, characterized as a rate-making adjustment, involves risk management premium fees incurred in the prior CPIM year, yet the corresponding benefits were realized in Year 8.[8] To address this situation, ORA reduced the shareholder reward predicated on actual Year 8 gas costs by half the amount of the premium fees at issue. ORA's calculation of the recommended PG&E shareholder reward is summarized in the following table:

ORA CPIM Year 8 Performance Summary

Item	Amount	Notes
PG&E costs.	$ 2,280,607,087	Figure reported by PG&E in CPIM report.
Financial swap adjustments.	$ 12,268,474	Added CPIM costs due to PG&E reporting error.
Total revised costs.	$ 2,292,875,561	
Tolerance Band lower limit.	$ 2,314,245,001	Consistent with PG&E report.
Amount below tolerance band.	$ 21,369,440	Sharable savings.
PG&E shareholder reward.	$ 10,664,720	50% of sharable savings.
ORA rate-making adjustment.	$ 2,994,423	Reconciliation of prior CPIM year premium fees.
ORA recommended reward.	$ 7,690,297	A $9,128,660 reduction from PG&E's initially reported request.

[7] ORA Year 8 PG&E Evaluation and Monitoring Report, p. 1-3.

[8] ORA notes on page 1-8 of its Year 8 PG&E Evaluation and Monitoring Report that it expressed its intent to account for the premium fees in this manner in its Evaluation and Monitoring Report for PG&E CPIM Year 7, dated October 5, 2001, Chapter 1, p. 1-3 and p. 1-4.

On December 23, 2002, PG&E filed AL 2431-G requesting a shareholder reward of $7,690,297 for CPIM Year 8. In the AL, PG&E explains that it adjusted the shareholder reward presented in its March 21, 2002 report by revising its gas costs upward due to the inadvertent omission of certain costs and updated settlement cost estimates. As a result, the utility's AL request is equivalent to that endorsed by ORA. The utility also states that it seeks to record the shareholder reward in the core and core subscription subaccounts of its Purchased Gas Account.[9] Additionally, PG&E states that it may seek to amend the shareholder reward upon the finalization of certain financial and physical settlement estimates.[10] The AL shareholder request is summarized in the following table:

PG&E AL 2431-G CPIM Year 8 Performance Summary

Total Commodity, Transportation and Storage Costs						
Tolerance Band			Actual Costs			
Upper limit	Total Benchmark	Lower Limit	Total costs incurred	Amount under Benchmark	Amount under Tolerance Band	Shareholder Reward
$2,379,882,261	$2,336,124,088	$2,314,245,001	$2,298,864,407	$37,259,681	$15,380,594	$7,690,297

On January 15, 2003, the Energy Division met with PG&E to discuss its Year 8 results and to provide the utility with an opportunity to comment on ORA's audit. The discussion focused on PG&E's efforts to mitigate the impact of the unprecedented 2000/2001 winter gas price spikes. The most significant actions taken were: 1) the use of call options when gas prices began to rise; 2) increasing gas storage inventory above the core allocation, and; 3) restricting gas storage withdrawals until later in the winter when gas prices peaked. It was said that

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[9] Under Preliminary Statement Part C., 13 in PG&E's gas tariff specifies that the allocation between Core Procurement and Core Subscription customers is pro rata based on the quantity of gas sold during the period covered by the reward or penalty.

[10] Based on discussions with Energy Division, PG&E explained that these estimates are related to the liquidation of certain contracts by counterparties when PG&E's financial condition deteriorated. When the AL was filed, the settlement costs of several of these terminated contracts are in dispute with the matter being pursued in court through the proof-of-claim process in the utility's bankruptcy proceeding. PG&E states that if the counterparties prevail, its CPIM Year 8 gas costs would increase by approximately $4 million, and it would seek any shareholder reward adjustment in a future CPIM proceeding. PG&E indicated that a considerable amount of time may ensue before this matter is resolved.

these steps were the principle reasons why the utility was able to reduce gas costs below the tolerance band. On the subject of ORA's cost adjustments, PG&E generally described the difficulty of determining the exact costs resulting from the early termination of various financial swaps. Counterparties cancelled these financial instruments when PG&E became non-creditworthy. A dispute remains between PG&E and the counterparties concerning costs resulting from the termination of some of these financial instruments.

NOTICE

Notice of AL 2431-G was made by publication in the Commission's Daily Calendar. PG&E states that a copy of the Advice Letter was mailed and distributed in accordance with Section III-G of General Order 96-A.

PROTESTS

PG&E AL 2431-G was not protested.

DISCUSSION

Our review of ORA's audit of PG&E's CPIM Year 8 performance and the utility's AL request shows agreement on several key points. Most significantly both parties calculate the same tolerance band limits, conclude that the utility's gas costs are below the tolerance band, and derive an equivalent shareholder reward amount. This is an important factor in our decision since ORA is the primary entity responsible to verify the utility's CPIM performance and examine the relevant cost accounts.

To decide this matter, it is useful to recap the sequence of events leading to PG&E's filing of its AL shareholder reward request. First, PG&E issued its Annual CPIM Performance Report recommending that it receive a shareholder reward in the amount of $16,818,957 for Year 8. Following the release of this report, ORA conducted a comprehensive review and rigorous audit of the utility's CPIM gas cost accounts. Based upon its audit findings, ORA determined that the shareholder reward should be reduced by $9,128,660 due to the discovery of an additional $12,268,474 in gas costs and the reconciliation of premium fees paid in the prior CPIM year. With the apparent acceptance of ORA's audit findings (except for the discrepancy discussed below), PG&E submitted AL 2431-G requesting a shareholder reward of $7,690,297 - the same amount derived by ORA. Additionally, PG&E states in the AL that the shareholder reward is subject to future revision upon the resolution of certain financial and physical settlement estimates.

Since the shareholder reward amount under consideration has been verified by an ORA audit which was not challenged by PG&E, we will approve the utility's request of a Year 8 shareholder reward of $7,690,297, subject to revision as discussed below. PG&E shall record the approved shareholder reward in its core and core subscription subaccounts of its Purchased Gas Account, as provided for in Preliminary Statement Part D in its gas tariff.

With regard to PG&E's settlement cost estimates, the utility shall issue a supplement to its Year 8 Annual CPIM Performance Report when the disputed costs are finalized. This report shall show the amount of these costs and impact on the shareholder reward approved here as well as on any other CPIM element and is to be submitted to ORA for audit and the Energy Division. Following ORA's review, the utility shall file an advice letter requesting any resulting revision of the shareholder reward adopted here.

Although it does not change the shareholder award amount approved here, we note a discrepancy between the Year 8 gas costs verified by ORA and those identified in PG&E's AL. ORA's audit confirms that gas commodity and transportation costs incurred in Year 8 with the updated financial swap termination costs were $2,292,875,561. In the AL, PG&E reports total period gas costs of $2,298,864,407 (subject to possible revision as discussed above). The apparent source of this discrepancy is the treatment of premium fees paid in the prior CPIM Year. ORA considers the reconciliation of these fees as a "rate-making adjustment". Under this methodology, ORA reduced the shareholder reward computed using the verified gas costs actually incurred in Year 8 by half of the amount of the premium fees at issue. In contrast, PG&E shows these premium fees as a Year 8 gas cost although the expenses were booked in the prior CPIM year. Although each of these approaches yield the same shareholder reward amount, a variance results between ORA's audited gas cost figures and those provided by PG&E in their AL. We find ORA's methodology reasonable and will approve their treatment of the premium fees as a rate making adjustment.

We approve PG&E's shareholder reward conditionally because of the possibility that the utility as well as others engaged in behavior to manipulate gas prices during the 2000/2001 winter. To examine this and related issues, we opened an investigation into the circumstances surrounding the gas price spike of the 2000/2001 winter .[11] As we state in the OII, "If the investigation reveals that the conduct of respondents contributed to the gas price spikes at the California border during the named period, it may modify or eliminate the respondent's Gas Cost incentive Mechanism (GCIM), reduce the amount of the shareholder award for the period involved, or order respondents to issue a refund to ratepayers to offset the higher rates paid."[12] Additionally, the FERC is conducting a similar investigation into energy price manipulation.[13] Accordingly, PG&E's shareholder reward approved here may be revised in the future depending upon the outcome of these investigations. This action is consistent with the condition we placed on the shareholder reward approved for San Diego Gas & Electric Company in Resolution G-3341, dated January 30, 2003.

Finally, our review of this matter raises concerns about PG&E's diligence to properly record CPIM related expenses and the reporting of CPIM information to ORA and the Commission. We are troubled by the apparent understatement of over $12 million of financial swap expenses by PG&E in its March 2002 Annual CPIM Performance Report. This error was discovered by PG&E after conducting further analysis of its accounts at ORA's request. [14] Although ORA notes that it held meetings with PG&E to improve the flow of this type of information and Energy Division conferred with the utility on the subject of early contract termination costs, we are nonetheless concerned that the magnitude of the reporting error described by ORA may signify deeper issues about the utility's accounting practices, particularly with regard to risk management instruments.

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[11] Respondents to I. 02-11-040 are Southern California Gas Company, San Diego Gas & Electric Company, PG&E, Southwest Gas and Southern California Edison.

[12] I. 02-11-040, page 2. Although Phase I of the OII is concerned only with the Sempra utilities, we will investigate PG&E's activity in a subsequent phase.

[13] I. 02-11-040, pp. 5-7.

[14] ORA Year 8 PG&E Evaluation and Monitoring Report, pp. 2-4,5.

To bolster our confidence in the reporting of its CPIM costs and reinforce the integrity of future CPIM performance reports, we will require PG&E to submit a report fully describing the circumstances surrounding the omission of any costs or reporting errors in its Year 8 Annual CPIM Performance Report and to identify any steps it has or will implement to prevent a future occurrence. Additionally, PG&E shall provide a detailed description of its risk management accounting practices related to core gas procurement and explain how this information is reflected in its regulatory accounts and CPIM reports.[15] Furthermore, PG&E shall include in this report its policies for the inclusion, identification and reconciliation of estimated gas costs in its CPIM calculations and reports. We will defer our consideration of opening a formal investigation into the utility's CPIM related accounting practices until we receive this report and evaluate its contents.

COMMENTS

Public Utilities Code section 311(g)(1) provides that this resolution must be served on all parties and subject to at least 30 days public review and comment prior to a vote of the Commission. Section 311(g)(2) provides that this 30-day period may be reduced or waived upon the stipulation of all parties in the proceeding.

The 30-day comment period for the draft of this resolution was neither waived or reduced. Accordingly, this draft resolution was mailed to parties for comments, and will be placed on the Commission's agenda no earlier than 30 days from today.

On March 28, 2003, PG&E provided comments indicating its support for the draft resolution subject to one clarification. PG&E recommends that the draft resolution be amended to acknowledge that the utility discovered the reporting error following ORA's request for additional analysis and then provided this information to ORA with a reduced CPIM request for inclusion in the audit

[15] ORA notes on page 2-10 of its Year 8 PG&E Evaluation and Monitoring Report that it has worked extensively with the utilities in order to make standardized reporting work papers that fully disclose the financial risk operations frequently associated with gas procurement.

report. We have amended the draft resolution upon consideration of PG&E's comments and the description of this event presented in ORA's audit report.

FINDINGS

1. PG&E filed AL 2431-G on December 23, 2002 requesting a shareholder reward for CPIM Year 8 in the amount of $7,690,297.
2. PG&E AL 2431-G lists actual Year 8 gas costs of $2,298,864,407, a portion of which consists of financial and physical settlement cost estimates.
3. PG&E issued its CPIM Year 8 Annual Performance Report on March 21, 2002, presenting its gas costs, benchmark and tolerance band calculations and recommending a shareholder reward of $16,818,957.
4. ORA issued its Evaluation and Monitoring Report assessing PG&E's Year 8 CPIM performance on December 17, 2002.
5. ORA audit findings in its PG&E Year 8 Monitoring and Evaluation Report show that PG&E should receive a shareholder reward of $7,690,297.
6. ORA notes in its PG&E Year 8 Monitoring and Evaluation Report a reporting error found on PG&E's financial and swap and termination estimate in the amount of $12,268,474.
7. ORA audit findings in its PG&E Year 8 Monitoring and Evaluation Report confirm that PG&E's current report of gas costs for Year 8 are below the CPIM Year 2002 lower tolerance band and, therefore, meets the requirements for a shareholder reward.
8. ORA audit findings in its PG&E Year 8 Monitoring and Evaluation Report confirm that gas commodity costs and transportation costs reported by PG&E in the amount of $2,292,875,561 are recoverable from ratepayers as specified by the CPIM.
9. ORA audit findings in its PG&E Year 8 Monitoring and Evaluation Report state that PG&E incurred premium costs in CPIM Year 7 while the associated benefits occurred in Year 8.
10. ORA audit findings in its PG&E Year 8 Monitoring and Evaluation Report confirm that PG&E's financial deterioration resulted in the early termination of certain contracts resulting in an increase of the financial swap and termination costs in PG&E's portfolio of $12,268,474 during Year 8.
11. ORA revised PG&E's shareholder reward presented in its Year 8 Annual Performance Report by increasing utility gas costs $12,268,474 and through a ratemaking adjustment of $2,994,423 due to premium fees paid by the utility in Year 7.

12. ORA ratemaking treatment of premium fees incurred by PG&E in CPIM Year 7 is reasonable.
13. The shareholder reward could be revised in the future depending on the outcome of our investigation into the causes of high California border prices in 2000-2001, and on the outcome of the FERC's investigation into electric and gas market price manipulation.
14. The shareholder reward could be revised in the future following the resolution of certain PG&E Year 8 financial and physical settlement costs currently in dispute, subject to ORA audit.

THEREFORE IT IS ORDERED THAT:

1. PG&E AL 2431-G is conditionally approved. PG&E shall receive a shareholder reward for its CPIM performance during the period of November 1, 2000 through October 31, 2001 in the amount of $7,690,297, subject to revision or forfeiture following the completion of I.02-11-040 and FERC's related investigations. Additionally, the shareholder reward may be revised after the finalization of financial and physical settlement costs estimates referred to in AL 2431-G.
2. PG&E shall record the shareholder reward authorized in Ordering Paragraph (OP) 1 to its core and core subscription accounts of its Purchased Gas Account, as provided for in Preliminary Statement Part D of its gas tariff.
3. PG&E shall issue a supplemental Year 8 Annual CPIM Performance Report to ORA and the Energy Division upon finalization of the Year 8 financial and physical settlement costs estimates referred to in AL 2431-G. Within 20 days after ORA's review of the supplemental report, the utility shall file an advice letter requesting revision of the shareholder reward adopted in OP 1, if necessary.
4. Within 45 days of the effective date of this resolution, PG&E shall submit a report to ORA and the Energy Division explaining the circumstances regarding the omission of any costs or reporting errors in its March 21, 2002 Annual CPIM Performance Report and identify any steps it has or will implement to prevent a future occurrence. The report shall also include a detailed description of the utility's risk management accounting procedures related to core gas procurement and explain how this information is reflected in its regulatory accounts and CPIM reports. Additionally, PG&E is to provide its policies for the inclusion, identification and reconciliation of

estimated costs in CPIM calculations and reports. Recommendations for improving CPIM related accounting procedures and the reporting of CPIM information to ORA and the Commission shall also be included in the report.

This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed and adopted at a conference of the Public Utilities Commission of the State of California held on April 17, 2003, the following Commissioners voting favorably thereon:

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WILLIAM AHERN
Executive Director

MICHAEL R. PEEVEY
President
CARL W. WOOD
GEOFFREY F. BROWN
SUSAN P. KENNEDY
Commissioners

I will file a dissent.
/s/ LORETTA M. LYNCH
Commissioner